Decision 01-12-024 December 11, 2001

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of Roseville Telephone Company (U 1015 C) to Review Its New Regulatory Framework.	Application 99-03-025 (Filed March 8, 1999)

ORDER DENYING REHEARING OF DECISION (D.) 01-06-077

I. INTRODUCTION

On August 8, 2001, Roseville Telephone Company (hereinafter "Roseville") filed an Application for Rehearing on Decision (D.) 01-06-077, mailed July 9, 2001. In D.01-06-077, we reviewed Roseville's new regulatory framework (NRF) structure and addressed a variety of issues raised by an audit of Roseville's affiliate, and of its non-regulated operations, conducted by the Office of Ratepayer Advocates (ORA).[1] Roseville's petition asserts that we made two legal errors in the Roseville NRF Decision.

First, Roseville complains that we did not follow the law when we applied the sharing mechanism to Roseville, because our decision directly contradicts Commission precedent regarding sharing mechanisms relating to larger NRF companies, such as Pacific Bell and Verizon. Roseville asserts that our decision regarding the sharing mechanism is unsupported by the evidence in the record, and is based on our misunderstanding of the results of the ORA audit. Roseville argues that we acted in an arbitrary and capricious manner when we relied on results of operations as a factor in deciding not to retain the sharing mechanism.

[1] D.01-06-077 is hereinafter referred to as "Roseville NRF Decision."

Second, Roseville claims that we acted in an arbitrary and capricious manner when we relied on a general allocator to allocate costs between Roseville and its affiliates, contrary to reasonable principles of cost allocation.

We implemented the NRF structure for Roseville in 1997. In contrast, the NRF structure was implemented for Pacific Bell and Verizon in 1990. Roseville's NRF Decision is the result of the first triennial NRF review for Roseville. In, D.01-06-077, we ordered the retention of Roseville's sharing mechanism. We also adopted a general allocator, which relies only on expenses to allocate costs to Roseville and its affiliates. These were major issues that were litigated in this proceeding.[2]

A brief procedural history of this proceeding in relation to these issues follows: On October 26, 1998, an Assigned Commissioner's Ruling was issued in Roseville's NRF Review Proceeding granting ORA's Motion to Conduct an Audit of Roseville's Non-Regulatory Operations. Next, on March 8, 1999, Roseville filed an Application for its First Triennial Review of NRF, A.99-03-025. This Application requested that the sharing mechanisms be suspended.[3] On April 8, 1999, at the prehearing conference in this proceeding, the issue of the scope of the ORA audit and its tie-in with the NRF proceeding were discussed. At that point, there was no question that the audit and the NRF proceeding were linked. On June 14, 1999, we issued D.99-06-051 which ordered ORA to file and serve the audit report in this proceeding. The audit addressed affiliate and non-regulated telephone relationships of Roseville. On January 3, 2000, ORA filed its audit report in accordance with our Decision in D.99-06-051. On January 7, 2000 an Administrative Law Judge Ruling was issued in this proceeding setting schedules and issues. This ruling states that "[t]he issue is the consideration of the Office of Ratepayer Advocates' (ORA) audit results in relation to Roseville Telephone Company's (RTC) request for a suspension of sharing." On May 22, 2000, ORA

[2] See Roseville Reply Brief, pp. 5-17.

[3] Roseville's Application, p.4.

filed its Opening Brief, which contained a full discussion of the results of the audit. On June 20, 2000 Roseville filed its reply brief. The matter was then submitted.

II. DISCUSSION

A. Sharing Mechanism

Roseville supports its assertion that retaining the sharing mechanisms is illegal by claiming that D.01-06-077 represents the first pronouncement by the Commission (in over a decade of NRF regulation of Pacific Bell and Verizon) holding that the sharing mechanism is a regulatory tool to prevent cross-subsidization of expenses between a local exchange carrier and its affiliates.[4] However, Roseville fails to note that the companies subject to NRF regulation over the last ten years, Pacific Bell and Verizon, are national companies and have presented to us quite different regulatory issues than those faced by Roseville. The fact that we often apply different regulatory results for mid-size and smaller telephone companies like Roseville is consistent with the regulation of such companies compared to larger companies.

Next, Roseville complains that in D.01-06-077, we incorrectly interpreted the record in the case to conclude that Roseville has engaged in widespread cross-subsidization of affiliates.[5] Roseville claims that there is no evidence in the record to support our conclusion that Roseville has cross-subsidized affiliates to the disadvantage of firms competing with Roseville's affiliates.[6] However, Roseville fails to address the fact that the ORA audit is replete with instances where the audit found that Roseville had improperly shifted costs from non-regulated operations to regulated operations.[7] The evidence in the

[4] Roseville's Application for Rehearing, p. 3.

[5] *Id*. at p. 4.

[6] *Id*

[7] ORA OB, pp. 15-16.

record shows that Roseville dominates the service market in its territory, and, in fact, is the only major player in that market. For example, the evidence in the record demonstrates that Roseville's long-distance affiliate, which was only established in late 1997, surpassed Sprint in terms of market share in 1998, and MCI WorldCom in March of 1999.[8] Furthermore, the record shows that Roseville's financial earnings grew in the double digits in the period under investigation, particularly with respect to non-regulated earnings.[9] Moreover, the evidence in the record shows that Roseville had not lost business from its customer base. From 1995 through 1998, Roseville's overall access lines grew about seven to eight percent, and the number of customers grew from four to nine percent annually.[10] Roseville's own witness testified that its competitors only owned about 1.7 percent of Roseville's total access lines.[11] Similarly, Roseville's local usage base, which Roseville alleged in this proceeding was threatened by the competitive local exchange carriers, increased more than forty percent from 1995 to 1997.[12]

Thus, given the above, we were justified in making the decision to suspend Roseville's sharing mechanism, and did not commit legal error in doing so.

Roseville then contests our reliance on the results of operation when deciding whether the sharing mechanism is an appropriate tool for preventing cross-subsidization.[13] Roseville cites to the Pacific Bell and Verizon NRF Decision, D.98-10-026, and claims that in that case we did not use the results of operations to decide the sharing mechanism for those carriers. However,

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[8] ORA's OB, pp. 15-16

[9] *Id.*, pp. 10-11.

[10] *Id.*, p. 11.

[11] *Id.*

[12] *Id*

[13] *Id.* at p. 7.

Roseville fails to acknowledge that D.98-10-026[14] did not prohibit our use of a telephone company's results of operation when deciding the issue of sharing in other instances. Moreover, in D.99-06-051 (which involves the instant case) we held that such information could be considered in deciding the issue of sharing.[15]

We found as follows:

> ". . . we agree with the ACR that the audit has several purposes. While one purpose is to undertake timely and reasonable regulatory review to ensure that the sharing calculations are correct, another purpose is to ensure that the correct accounting policies, practices and procedures have been implemented, and are being used accurately, not only for 1997, but also for 1998, and in place thereafter, for holding company and non-regulated operations. Another purpose is to provide information as part of the Commission's review of Roseville's NRF, including consideration of whether to suspend sharing." (D.99-06-051, p. 10, supra, emphasis added.)

Therefore, Roseville's argument that it is arbitrary and capricious for us to use Roseville's results of operations in deciding the issue of the sharing mechanism is not consistent with the record or with our pronouncements on this matter in D.99-06-051. In fact, Roseville's argument is tantamount to asking us to completely ignore the existing evidence in the record and legal precedent that is relevant to the issue of sharing.

B. Allocation Methodology

Roseville's next contention of legal error relates to our adoption of an allocation method for general and administrative costs attributable to affiliates. In the instant proceeding, ORA challenged Roseville's allocation of general and

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[14] Rulemaking on the Commission's Own Motion into the Third Triennial Review of the Regulatory Framework, D.98-10-026 (October 8, 1998), 1998 Cal. PUC LEXIS 669.

[15] In the Matter of the Application of Roseville Telephone Company to restructure intrastate rates and charges and to implement a new regulatory framework for telephone services furnished with the State of California, D.99-06-051, p. 10 (June 10, 1999), 1999 Cal. PUC LEXIS 308.

administrative costs between Roseville and its affiliates. Roseville proposed to allocate this group of costs based on a three-factor formula. These three factors are gross payout, total expenses and employee head count. In contrast, ORA proposes that costs be allocated by using a general allocator, which relies solely on expenses.[16]

Roseville complains that our adoption of the general allocator approach is arbitrary and capricious, and that we committed legal error by adopting it. However, our decision to use a general allocator which relied solely on expenses is consistent with the Federal Communications Commission's (FCC) requirements that

> "[w]hen affiliates provide shared services to each other that are not being provided to unaffiliated persons or entities, the cost must be apportioned in a manner which complies with standards and procedures for the apportionment of joint or common costs between the regulated and the non-regulated operations of a carrier entity."[17]

We rejected Roseville's three-factor formula based on the fact that it did not comply with Part 64 of the FCC Rules.[18] It should be noted that Roseville agreed in this proceeding that the FCC's Part 64 Rules should apply.[19] Moreover, in this Decision, we go into depth to explain why the general allocator must be used to allocate residual costs between Roseville and its affiliates. D.01-06-077 correctly notes that Part 64 of the FCC's Rules establishes a hierarchy of allocating costs. These rules require that costs be allocated as directly as possible, and if no direct basis can be found, then an indirect, cost-causative linkage can be

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[16] Roseville's Application for Rehearing, p.10.

[17] Report and Order, FCC Docket No. 86-111, at 229. Specifically, ¶ 122 of the FCC decision discusses the proposal to use the three-factor formula, ¶¶ 156 and 157 reject the use of allocators other than an allocator based on expenses, the general allocator. The paragraphs in between ¶126 and ¶156 provide the rationale for rejecting other allocation methods.

[18] Cfr., Title 47, §64-901(b)(iii); D.01-06-077, p.46; ORA's OB, Audit Calculation 31.

[19] D.01-06-077, p. 46.

made.[20] We go on to say in our decision that "[t]he fact that RTC claims that its three-factor formula is based on cost causation does not make it so."[21]

We conclude that

> "[t]he issue here is whether the factors identified by RTC would generally approximate the extent to which common, general and administrative costs are caused by RTC, on the one hand, or RTC's regulated affiliate, on the other hand. . . . We are persuaded by ORA that RTC's three-factor formula does not reflect cost causation and instead over-allocates costs to RTC. ORA correctly points out that the three-factor formula over emphasizes asset accumulations, both through the gross plant factor and through depreciation expenses reflected in the expense factor. As a mature company, RTC has accumulated considerable assets over a long period of time. In contrast, in a dynamic and fast-changing period in the telecommunications industry, most of RTC's affiliates – including RDC, RLD, Roseville PCS and RCS Wireless, and RCS Internet – were just coming into existence during the audit period. Even though these affiliates obviously require the expenditure of general and administrative costs, they have had little time to accumulate assets. Consequently, the use of accumulated assets as a significant factor in allocating common costs – as reflected in the gross plant factor of the depreciation component of the expense factor - does not provide a reasonable approximation of the extent to which affiliates caused common costs to be incurred."[22]

We then cite to specific audit findings to point out why Roseville's three-factor formula failed the cost-causative test.[23] We find that

> "[the] reasoning of the FCC's Order … in which it modifies the Part 64 rules applied here buttress our conclusion that RTC's three-factor formula over-

[20] *Id.*

[21] *Id.* at p. 47.

[22] *Id*. at p. 47.

[23] *Id*. at p. 48.

> emphasizes past activities as an estimator of current cost causation.…In this environment, use of an allocator – such as RTC's three-factor formula – that emphasizes past asset accumulation would 'consistently understate' usage by unregulated affiliates."[24]

These conclusions are fully supported both by record evidence and by legal precedent. Thus, we did not commit any legal or factual error when we adopted the general allocator to allocate residual costs between Roseville and its affiliates.

III. CONCLUSION:

Our decisions on these issues are properly based on record evidence and applicable law. Roseville's claims of legal error are without merit. Therefore, Roseville's Application for Rehearing is denied.

THEREFORE, IT IS ORDERED that:

1. Rehearing of D.01-06-077 is denied.

This order is effective today.

Dated December 11, 2001, at San Francisco, California.

LORETTA M. LYNCH
President
HENRY M. DUQUE
RICHARD A. BILAS
CARL W. WOOD
GEOFFREY F. BROWN
Commissioners

[24] *Id*. at p. 49.